
BEFORE THE
FEDERAL COMMUNICATIONS COMMISSION
WASHINGTON, D.C. 20554

RECEIVED

MAY - 7 1996

FEDERAL COMMUNICATIONS COMMISSION
OFFICE OF SECRETARY

DOCKET FILE COPY ORIGINAL

In the Matter of)
)
Federal-State Joint Board on) CC Docket No. 96-45
Universal Service)

REPLY COMMENTS OF
SOUTHWESTERN BELL TELEPHONE COMPANY

Robert M. Lynch
Durward D. Dupre
Michael J. Zpevak
Darryl W. Howard

Attorneys for
SOUTHWESTERN BELL TELEPHONE COMPANY

One Bell Center, Suite 3524
St. Louis, Missouri 63101
(314) 235-2513

May 7, 1996

No. of Copies rec'd
List ABCDE

024

TABLE OF CONTENTS

I.	The Definition of Universal Service	2
II.	The Subscriber Line Charge and the Carrier Common Line Charge	5
III.	Schools, Libraries and Rural Health Care Providers	9
IV.	To Comply with the Requirements of the Act, the Actual Cost of Providing Universal Service Must be Used in Determining High Cost Areas and Fixing Support	11
	A. The Act Requires Explicit Support To Be “Sufficient”	12
	B. Support Based Upon TSLRIC Would Not Be Sufficient	13
V.	Funding	17
VI.	Affordability	18
VII.	To Replace Implicit Support, Universal Service Areas Must Be Smaller Than Current Study Area Boundaries	19
VIII.	The Need for Capital Recovery by Incumbent LECs	20
IX.	Toll Restriction	21
X.	Incremental Step	22

SUMMARY*

The comments filed in this proceeding are diverse, demonstrating a lack of any industry consensus on the many issues confronting the Joint Board, the Commission, and the State commissions. The only true agreement is that the current method of using implicit support to fund universal service must be replaced. The Joint Board and the Commission must exercise caution in fashioning universal service mechanisms, and should strive to adopt a relatively simple, easily implemented and administered approach. The USTA plan meets those objectives in providing support at the interstate level. In contrast, those plans that preclude the recovery of the actual historical costs of providing universal service fail to meet the requirements of the Act.

With the clarifications and few additions suggested by SWBT, the definition of universal service contained in the NPRM should be adopted. The Act was not intended to result in a new entitlement to free or artificially cheap service, or to be used to provide advanced services before a substantial majority of households subscribe to the service. Since Internet access and voice mail are “information services,” neither can be included in the definition of universal service.

There is a very broad consensus that the CCL charge should be eliminated, with many supporting an increase in the SLC as the means of recovering the costs now recovered by the CCL charge. Increasing the SLC would both be economically efficient in that loop costs would be recovered from its causer and, as studies have consistently demonstrated, would be in the public interest and benefit the average subscriber. The expanded and explicitly funded Lifeline program would help ensure that the SLC increase has no adverse effect on subscribership.

Schools, libraries, and rural health care providers play critical roles in our society, and SWBT firmly believes telecommunications can make a difference in helping each fulfilling their

* The abbreviations used in this Summary are as defined in the main text.

role. However, there appears to be no consensus on what basic or advanced telecommunications services are needed, and there is a risk of untargeted and unnecessary spending. SWBT supports the USTA plan for funding schools and libraries, and the integrated distribution of those funds to coincide with other improvements where possible and as determined and coordinated by State administrative boards. A separate fund and funding mechanism should be established for these funding purposes.

The actual historical costs of providing universal service must be used to ensure that support is “sufficient” under the Act and that universal service obligations do not result in a regulatory taking. Use of the MCI/Hatfield cost proxy model based upon TSLRIC is clearly insufficient, both for specific deficiencies in that model and for use of its TSLRIC formulation. Basing universal service support on a forward-looking calculation using current technologies ignores the fact that neither incumbent LECs nor any eligible carrier can actually build a network in such a fashion. Moreover, TSLRIC also ignores the joint and common costs that are necessary for provision of service, and that the Act contemplates will be included in both the pricing and support of universal service. TSLRIC will not permit any eligible carrier to remain financially viable in the long-term in the provision of universal service.

The Joint Board and the Commission should adopt the use of interstate retail telecommunications revenues as the funding base for universal service. Of all the alternatives, interstate retail revenues eliminates issues of “double taxation,” does not create disincentives to purchase services from other carriers, and eliminates support implicit in prices.

SWBT and others agree that, based upon its past performance, NECA should be strongly considered for the role of neutral third party administrator of universal service funds.

Affordability should be set at 1% of the State's median income.

The Joint Board and the Commission should not endorse the current study areas as the proper geography for large LECs in determining the need for universal service support.

Otherwise, the implicit support intended by the Act to be eliminated will remain. Universal service areas should be no smaller than the wire center level and no larger than a basic local calling area.

As commenters noted, separate funds should be established to permit incumbent LECs to recover, over a five-year period, under-depreciated past investment caused by setting depreciation rates low to keep LEC prices low. These separate funds should be separately identified and not portable.

Toll restrictions should not be included within the definition of universal service. Instead carriers and the States should be left to address this issue. LECs are developing new toll management systems to help customers control their toll usage.

If the Joint Board and the Commission are unable to adopt all of the provisions of the USTA plan in this proceeding, the following relatively simple, reliable components of the USTA plan should be used instead:

- Increase the residence and single-line business SLC cap gradually, for example, over four years, to \$6.00 per month.
- Reduce CCL on a revenue-neutral basis to coincide with the SLC increases. Bulk bill the CCL to IXC's during the transition (i.e., until the SLC increases are completed).
- At the end of the transition, place any remaining Common Line cost recovery into the Federal universal service high-cost fund.
- Expand and explicitly fund Lifeline.

- **Establish target rate levels above which basic local exchange service (and the related interstate rate elements) would be deemed unaffordable and above which high-cost support would be required.**
- **Determine costs based on a simplified version of the Part 36 Rules and procedures that define loop costs. (All eligible carriers would be able to comply with these simplified loop cost rules.)**
- **Require funding of the high-cost fund by all telecommunications providers through an explicit surcharge on each provider's retail interstate telecommunications revenues.**
- **Universal service fund amount would be determined by loop costs not recovered by SLC.**

Before the
FEDERAL COMMUNICATIONS COMMISSION
Washington, D.C. 20554

In the Matter of)	
)	
Federal-State Joint Board on)	CC Docket No. 96-45
Universal Service)	

REPLY COMMENTS OF
SOUTHWESTERN BELL TELEPHONE COMPANY

Southwestern Bell Telephone Company (SWBT) files these Reply Comments in response to the comments filed on April 12, 1996, pursuant to the Notice of Proposed Rulemaking and Order Establishing Joint Board (NPRM) issued in this proceeding. Those comments present a broad range of responses to the twin goals in the Telecommunications Act of 1996 (Act) of preserving and promoting universal service and promoting telecommunication competition. Of all the suggestions filed, the USTA plan which SWBT supported in its Comments best addresses the goals of both the Act and the Commission, while providing State commissions the latitude to adopt complementary intrastate universal service plans.

The diversity of the suggestions and recommendations in various comments is pronounced, illustrating the difficulty of the task that the Joint Board, the Commission, and the States have before them. All parties agree, however, that using the current price structure to provide implicit subsidies is neither sustainable nor desirable, and that those implicit subsidies must be replaced with explicit subsidies funded on a competitively neutral basis.

With no clear or easy path, the Joint Board will be challenged to develop a plan that weighs this diversity of suggestions and balances the goals of preserving/promoting universal service and fostering competition. The Joint Board and the Commission must exercise caution to

not take actions so drastic as to substantially harm any specific group. The intent of the Act in preserving universal service is not to engage in a taking from the local exchange carriers (LECs) that have historically been relied upon by the public to provide universal service, so that another group, or groups of providers might significantly benefit.

The Joint Board and the Commission should seek a simple, easily implemented and administered approach that complements the Act's pro-competitive and deregulatory intent. In defining universal service and creating explicit universal service support, the Joint Board and the Commission should avoid complex structures that competitively disadvantage or administratively burden, through regulatory oversight, any class of carriers. Minimal interference with competition and competitors should be an objective with universal service as with other aspects of the Act.

SWBT believes that a solution is one that provides universal service at affordable prices and that allows eligible carriers to receive an acceptable level of high-cost support. The USTA plan is reasonable, well-constructed and achieves the goals of the Act with respect to interstate costs. Many of the other proposals contain serious, sometimes fatal, flaws that often seek to achieve competitive advantage through this proceeding. Plans that preclude the recovery of the actual costs of providing universal service simply do not meet the Act's requirements that the support be "sufficient" and ensure the ultimate failure of this proceeding as universally available networks could not be sustained in rural and other high-cost areas.

I. The Definition of Universal Service

While most parties agreed with the definition of universal service proposed in the NPRM, some commenters want to stretch that definition far beyond the criteria set forth in Section 254. Those asserting that access to a broad range of telecommunications services is a "birthright of

citizenship”¹ and those claiming that digital service, Internet access, and access to interactive services must be included² miss the entire point behind universal service. Congress did not enact Section 254 to create a vehicle by which “off-balance sheet” entitlements could be meted out based upon special interest desires for free or abnormally cheap service, or to address every social ill or injustice. Instead, the universal service criteria and support mechanisms are intended to ensure that the Nation’s long-held concept of universal service does not erode under the competitive pressures created by the Act. In fashioning a definition of universal service, the principles set forth in Section 254(c)(1) should be strictly and reasonably applied.

Under those principles, the reliance on market forces evidenced by Section 254(c)(1)(B) is particularly telling of the intent of Congress. As opposed to the separate authority granted to develop separate definitions for schools, libraries, and health care providers, this general provision is clearly intended to keep the Joint Board’s and the Commission’s focus on the telecommunications demands of the vast majority of households, even if the definition of universal service is not limited solely to residential service (e.g., voice-grade local service to business customers). Thus, while Congress clearly understands that uneconomic investment choices must be made in order to provide core service, it does not intend that such choices be encouraged or required in advance of a substantial majority of households deciding to actually purchase a telecommunications service. The Act simply does not authorize or sanction funding networks that, if deployed unilaterally by a LEC subject to rate base, rate of return regulation, would be

¹ People for the American Way et al., p. 2.

² See, e.g., Robert A. Hart IV, p. 2 (basic ISDN); Nebraska Rural Development Commission, p. 3 (Internet access, broadband capabilities); Association of Bar of the City of New York, p. 15; Wyoming Public Service Commission, p. 7.

condemned as “gold plating.” Including advanced services based upon speculation about what the market “should want” will just impose unnecessary costs on the public for services that might not meet any real market demand. The best approach is to allow the market to make its choices and then modify the definition of universal service if those market-accepted selected services meet the criteria of Section 254(c)(1) but yet are not being provided to all areas of the country at affordable rates.

A number of commenters championed Internet access to be included within universal service. Internet access is inherently an “information service” (47 U.S.C. 153(20)) and thus statutorily falls outside of any possible definition of universal service.³ While Internet usage may be increasing rapidly, only about 5-15% of residence customers currently avail themselves of Internet access.⁴ Voice mail service is also an information service that falls outside of the purview of Section 254.⁵ As such, both fail to meet any reading of Section 254(c)(1)(B).

Finally, there is a need to clarify the difference between including “access to” a service within the definition of universal service, and the associated “use of” the service itself. By supporting the inclusion of access to emergency services (911/E911) where provided by local authorities, SWBT does not mean to suggest that the current funding mechanisms for 911/E911 be replaced with universal service support mechanisms, or that an eligible carrier be required to

³ Section 254(c)(1) (“Universal service is an evolving level of telecommunications services . . .”). Accord Interactive Services Association, pp. 6-13.

⁴ See CommerceNet/Nielsen, Internet Demographic Study, August 1995, p. 8 (“11% (24 million) of total persons aged 16 and above in the US and Canada have used the Internet in the past three months.”) Information about the proprietary study can be found at <http://www.nielsen.com>.

⁵ The United States Catholic Conference et al., pp. 8-10.

provide 911/E911 service if such a service has not been established by State or local government. Instead, SWBT supports requiring an eligible carrier to make access to those services available where offered and, to the extent that the costs for such access are separately identifiable, universal service support may be appropriate for that access only (but not for the service itself).⁶ Universal service should not include the use or costs of 911/E911 services, basic operator services, or basic local directory assistance.

II. The Subscriber Line Charge and the Carrier Common Line Charge

Generally speaking, few opposed eliminating the interstate carrier common line (CCL) charge and recovering the non-traffic sensitive (NTS) costs through a more efficient means. The consensus on this point was wide, encompassing LECs, interexchange carriers (IXCs), and State commissions (e.g., California Public Utility Commission).⁷ Notwithstanding the apparent misunderstanding of some,⁸ the CCL charge is a clear implicit subsidy of the type sought to be eliminated under Section 254. The Joint Board should therefore recommend, and the Commission should adopt, the replacement of the CCL by increasing SLCs and providing high-cost funding where the SLC price exceeds an affordability benchmark. The real issue then becomes from whom should those NTS loop costs be recovered. The process begun by the Commission over ten years ago should be completed, and those loop costs should be recovered from the end-user.

⁶ See Illinois Commerce Commission, pp. 3, 47.

⁷ See, e.g., SWBT, p. 4; AT&T, p. 16; California Public Utility Commission, p. 20.

⁸ Bell Atlantic, p. 11, NYNEX, p. 7.

SWBT opposes converting CCL charges into bulk-billed charges to IXC's as a long-term or permanent solution, as some commenters suggest.⁹ Bulk-billing only eliminates the economically inefficient recovery of NTS costs on a usage-sensitive basis. The other half of the economically efficient solution -- shifting the cost to the cost-causing end-user -- would remain unsatisfied. The interstate loop costs recovered by the CCL result from the dedication of a loop for the use of the local service user, which does not change regardless of whether that user makes a toll call; those NTS costs are simply not a cost of providing switched access. To require one party (IXC's) to pay those costs on behalf of another (end-users) and then be forced to recover those costs from toll users continues the implicit support process that should be eliminated. To the extent that any residual CCL amounts are billed solely to IXC's during the transition period while SLC's are gradually increased, those amounts should be bulk-billed until the transition is complete. Any remaining CCL amounts would then be included in the high-cost fund.

The principle of cost causation seeks recovery from those who create the cost. Bell Atlantic's "moderate approach" of charging IXC's for a portion of NTS loop costs would only again lead further into the quagmire of wholly arbitrary implicit cost recovery mechanisms.¹⁰ Bell Atlantic's position is that every party benefiting from the use of the common line, whether or not they cause the cost, should pay some portion of associated charges. Logically extended, a mail order company that makes a sale because of a customer-initiated telephone order should be assessed some portion of that customer's NTS loop cost. Inevitably, this would lead to an untold

⁹ See, e.g., National Association of Regulatory Utility Commissioners, pp. 12-18; State of Maine Public Utilities Commission et al., pp. 15, 16; Idaho Public Utilities Commission, p. 17.

¹⁰ Bell Atlantic, p. 12.

number of arbitrary cost assignments, thereby abandoning any link to cost causation. The LEC incurs the full NTS loop cost by fulfilling the end-user's request for access to the public switched network (regardless of the end-user's subsequent network usage), making those NTS loop costs solely attributable to the end-user and most appropriately recovered through the SLC.¹¹ The Commission agreed.¹²

Much of the opposition to raising the SLC is based upon a faulty premise -- that end-users will inevitably pay a higher amount for telecommunications services. That premise fails to take into account that when interstate CCL reductions have actually been used to reduce interstate toll rates, consumers on the whole clearly benefit. Studies of consumers' telecommunications expenditures conclude that the average customer benefits from this form of economically rational rate rebalancing. Not only do consumers benefit in real dollar terms when IXC's pass on the access price reductions to end-users, there are no negative effects on subscribership.¹³ This would further be assured by expanding Lifeline as SWBT recommends.

¹¹ See Alexander C. Larson & Steve G. Parsons, "Building Block" Cost Methods for Pricing and Unbundling Telecommunications Services: Implications for the Law and Regulatory Policy, 36 *Jurimetrics Journal* 59, 80-83 (Fall 1995), for a refutation that the loop is a common costs, or that its recovery should be spread among many services.

¹² *MTS and Wats Market Structure*, CC Docket No. 78-72, Phase I, 97 F.C.C.2d 682, 688 para. 10 (1983) ("The cost of a common line is attributable to the user who has that line"). See also Alfred E. Kahn & William B. Shaw, *Current Issues in Telecommunications Regulation: Pricing*, 4 *Yale Journal on Regulation* 191 (1987).

¹³ AT&T, pp. 7, 8, 16 n.21.

Such reductions would actually lessen the concern expressed by the Commission that it is the inability to pay toll charges that most often leads to local service disconnection.¹⁴

Notwithstanding the clear public benefit of CCL reductions and SLC increases and the overall benefit that the average end-user will experience, SWBT acknowledges that some customers will pay more than previously. Such a result is to be expected as implicit subsidies are removed from LEC rates. Clearly Congress understood that reality, and intends that this proceeding address increases that have the potential of harming universal service objectives. Consistent with that objective, the USTA plan would both deaverage the SLC (resulting in SLC decreases to low-cost customers) and cap the SLC (regardless of the actual cost). To take an example, interstate loop costs for SWBT wire centers range from a low of slightly less than \$1.50/month to a high of more than \$70.00/month. Assuming SLC prices were deaveraged to the wire center level, over 30% of SWBT customers would be assessed a lower SLC charge than they are assessed today. In other words, 30% of the customers would experience a SLC rate reduction and reductions in interstate toll rates. The remaining lines would see an increase in the interstate SLC no greater than \$2.50/month, phased in over four years, assuming a \$6.00/month affordability benchmark for the interstate SLC. Moreover, qualifying low-income subscribers would be protected by an expanded Lifeline program. Implementation of the USTA plan with a \$6.00 interstate affordability benchmark would result in only 36% of SWBT's lines requiring explicit universal service support on the interstate level.

¹⁴ *Amendment of the Commission's Rules and Policies to Increase Subscribership and Usage of the Public Switched Network*, CC Docket No. 95-115, Notice of Proposed Rulemaking, (1995) (citing various studies at para. 10 n.8).

Increases that do not make customer access unaffordable are entirely consistent with the Act and the desire to minimize the size of any explicit fund.¹⁵ This proceeding does not furnish a basis on which to reject the removal of an implicit subsidy because it may increase some prices. To do so would be to turn this proceeding on its head. The Joint Board and the Commission should adopt the USTA plan to shift the cost recovery currently accomplished by the CCL to a deaveraged capped SLC with any remaining costs being recovered from an explicit universal service fund. At the inception, such a rebalancing must be revenue neutral.¹⁶

III. Schools, Libraries and Rural Health Care Providers

SWBT supports the USTA position on funding for schools and libraries as a prudent, fair and effective way to ensure that schools and libraries have access, through telecommunications capabilities, to databases, video services and other educational applications. It is not reasonable to expect, nor did the Act envision, that the telecommunications sector would foot the entire bill for all of the various training, software, hardware and infrastructure costs associated with bringing advanced telecommunications to these sectors of the economy. The telecommunications industry in general and local exchange providers in particular should not be solely responsible for the support of the telecommunications needs of schools and libraries. The USTA plan thus

¹⁵ The Missouri Public Service Commission, pp. 19-20, implies that the SLC acts as a barrier to access for all customers. Although charging anything for universal service can logically be said to create a “barrier,” the inquiry should instead focus on whether the charge for universal service is reasonable and affordable by the vast majority. Given the goals of the Act and Section 254 in particular, the SLC increase proposed by USTA would violate neither standard. For those who would find the increase unaffordable, better, more targeted programs should be used (*e.g.*, Lifeline, Link Up). Perpetuating the current state of “implicit subsidies for all” is simply not consistent with Section 254.

¹⁶ Sprint, p. 19.

establishes a reasonable level of funding for schools and libraries by limiting funding to telecommunications services.

Not all schools and libraries may need or want the highest level of telecommunications technology or services. Allowing the States through administrative boards to determine the distribution of the funds provides a means for meeting the needs of local schools and libraries while integrating that distribution with other educational infrastructure improvements.

The educational service fund should be both determined and funded separately from the general universal service fund. A separate explicit fund would accurately target the needs and proper accounting of this explicit subsidy would be assured. With a separate support fund in place, an administrative board with the expertise to understand educational needs could establish the criteria by which funds would be distributed. Special consideration could be based on whether the schools and libraries are in rural or low-income areas, or other criteria as necessary to ensure that funds get to the proper educational organizations to achieve the Act's goals. Such a proposal could ensure affordable telecommunications services are being provided to schools and libraries and would provide flexibility for educational institutions to purchase services to meet their unique needs. No party takes issue with the critical role that schools, libraries and rural health care providers play within our society, or with the conclusion that making basic and certain advanced telecommunications services available to those institutions is an important priority. With an important variation in wording, SWBT agrees with the National School Board Association (NSB) statement that "the effective use of advanced telecommunications technology is already an essential employment skill, as important as the traditional 'three R's.'" SWBT would suggest that the effective use of telecommunications, both basic and advanced, can be an effective complement

to the "three R's" in the development of essential employment skills. Access to telecommunications alone will not solve all the problems of schools. To effectively realize the full potential of our schools and libraries, there must be a partnership among all stakeholders -- schools, libraries, Federal, State, and local government, business, communities, parents, and students.

There is no consensus on the types of services that should be provided under a discount as provided by the Act. The Commission does not now have the expertise to determine the needs of schools and libraries (especially at this early date in the process). Notwithstanding NSB's conclusion that "there will not be a rush to spend as much money as possible," a number of parties correctly caution that the potential costs of support to schools and libraries throughout the United States could be very high, placing massive burdens on telecommunications providers and the users of the telecommunications networks.¹⁷ Prudent and effective identification of need and utility, and effective administration of the use of funds, would help avoid a "mad rush" to obtain and spend as much as is made available to obtain every available capability. The design and administration of any fund should ensure that there is not a rush to spend as much money as possible.

IV. To Comply with the Requirements of the Act, the Actual Cost of Providing Universal Service Must be Used in Determining High Cost Areas and Fixing Support

SWBT supports the use of Part 36 and access rules and procedures currently used to define loop costs for the determination of "high cost." These methods and procedures are in place and provide a reasonable, relatively simple basis for the initial determination of the actual costs of providing universal service. Rather than debate new unproven procedures, it would be

¹⁷ See, e.g., Washington Utilities and Transportation Commission, p. 15.

better to use the existing rules and procedures, with some simplification for new entrants, to establish a baseline universal service cost level. More importantly, using actual historical costs of providing universal service is the only way to meet the sufficiency requirements of the Act.

SWBT supports the USTA plan's concept of identifying the costs to provide universal service only once, at the inception of the new explicit support mechanism.¹⁸ If other eligible carriers are unable to identify their costs, according to simplified Part 36 and access procedures, for a given service area, they could receive the same level of high cost support per line as the incumbent LEC. The carrier that serves the customer would receive the support.

A. The Act Requires Explicit Support To Be “Sufficient”

One of the principles of universal service repeatedly required by Congress is that the explicit support mechanisms must be “sufficient” to “preserve and advance universal service.” Sections 254(b)(5), 254(d), 254(f). The dictionary definition of “sufficient” is “marked by quantity, scope, power, or quality to meet with the demand, wants, or needs . . . of a proposed use or end.”¹⁹ Congress clearly required that universal service support permit recovery of the full cost of providing universal service. Absent an ability of an eligible carrier to recover its actual historical costs of providing universal service in an service area from the subscribers of universal service, the support to be provided pursuant to the Act must be “sufficient” to eliminate that deficit. Arguments that some theoretical cost measure or model be used miss this Congressional directive entirely if the results of those schemes are not at least reasonably comparable to the level

¹⁸ If necessary, the support per line could be adjusted over time through a "price cap"-like adjustment to recognize the affects of inflation and/or efficiency gains. This process would wholly eliminate the need for ongoing cost studies and their subsequent review.

¹⁹ Webster's Third New International Dictionary (1981).

of costs actually incurred in providing universal service. Eligible carriers do not suddenly build entirely new networks using the latest theories and technology to provide services in a perfectly uniform world. In the real world, eligible carriers will have incurred and will continue to incur real costs to build and maintain actual networks with the most-efficient, then-available technology in order to provide universal service. If those real costs cannot be recovered from customers or through the required explicit universal service mechanisms,²⁰ the Joint Board and the Commission will not have fulfilled the legislative mandate.

To avoid running afoul of the Act or the law on impermissible takings, incumbent LECs and other eligible carriers must be permitted to recover the actual historical costs of providing universal service.

B. Support Based Upon TSLRIC Would Not Be Sufficient

Assume that a person bought a house for \$100,000, with a mortgage payment of \$800/month. After being in the house for a few years, that person calculated that the house would only cost \$80,000 to duplicate and began sending the bank monthly checks for \$640 to reflect the analysis that the house should now be 20% cheaper. In a short time, the bank would evict that homeowner and repossess the house for failing to pay the mortgage. In the same way, cost proxies using TSLRIC studies that assume away actual costs in favor of theoretical universal service costs prevent incumbent LECs from recovering costs incurred.

²⁰ The Act does not contemplate eligible carriers being required to implicitly fund their obligations in a universal service area by increasing rates to customers for other services and/or in other service areas. Requiring continuation of that practice may help those in competition with incumbent LECs and other eligible carriers by creating higher price umbrellas and resource drain, but the society as a whole will continue to be the net loser since such practices would continue to facilitate uneconomic market entry and higher prices.

Any cost proxy model that does not reasonably reflect the actual costs that an eligible carrier incurs in providing universal service is simply “insufficient” as a matter of law.²¹ Some commenters are quick to suggest extremely low cost estimates as appropriate in determining the cost of providing local exchange service and universal service support regardless of demonstrable inaccuracies. As an example of this, the MCI/Hatfield variant of the BCM uses depreciation rates that are well below the average of the depreciation rates currently prescribed by the Commission for the LECs.²² Across the board, the MCI/Hatfield BCM model uses “loading factors” that are insufficient.

Beyond those fallacies, the recommendations of MCI and others fail because they rely on incremental costs that have nothing to do with actually constructing and operating a network to provide universal service. Using Total Service Long Run Incremental Cost (TSLRIC),²³ several parties claim that local exchange rates are already efficiently priced²⁴ and, to the extent that high-cost support is necessary, both high-cost areas and universal service support should be determined

²¹ See, e.g., U S West, at p. 11, acknowledges that its proposal (the BCM using ARMIS overhead cost estimates) would not cover its full costs of providing basic universal service today.

²² The MCI/Hatfield version of the BCM applies “scorched earth” views of network design because it assumes that the network for which cost proxy estimates are generated is designed from scratch by a single carrier at the instant the service is provided, and that expected fill factors and other aspects of capacity utilization are very efficiently known with almost perfect foresight.

²³ Results from those studies have also been used to recommend that the LEC access rates be reduced to a TSLRIC level. See AT&T, pp. i, 4, 5; MCI, p. 15. These commenters lose sight of the fact that this docket is not generally about pricing switched access. SWBT strongly disagrees with those IXCs that suggest the proper remedy for the existence of implicit subsidies is to remove them entirely from LEC access rates without any offsetting adjustments or considerations. See, e.g., MCI, p. 14; Telecommunications Resellers Association, pp. 13-14.

²⁴ AT&T, pp. 2, 7-8, 16 n.21

using TSLRIC calculations.²⁵ These recommendations ignore that no carrier can construct and maintain a ubiquitous network for the prices indicated by the MCI/Hatfield TSLRIC studies or for that matter any properly constructed incremental cost study. As explained in the attached analysis prepared by Dr. Richard D. Emmerson, pricing services at LRIC does not allow recovery of reasonable joint and common costs. Thus, TSLRIC is not the proper basis for establishing sufficient universal service support.

The principal problem with TSLRIC studies is that, by definition, incremental cost measures only those costs which are unambiguously associated with the production of a particular service. The fixed, joint, common, and shared costs inherent in providing universal service are insufficiently accounted for in MCI's TSLRIC measure. This misplaced focus on incremental costs could gravely damage incumbent LECs. Regulators have been directed by Congress to replace all universal service subsidies implicit in LEC rates with an explicit subsidy mechanism. Regulators, however, should not automatically focus on differences between LEC incremental costs and tariffed rates for local telephone service. Such a comparison will not yield an accurate estimate of the extent of universal service support currently embedded in LEC rate structures. Incremental costs typically reflect the use of forward-looking technologies and production processes and generally ignore the costs of complying with regulatory obligations. Hence, incremental costs do not reflect the expenditures actually incurred to fulfill carrier-of-last-resort and universal service obligations. To ensure potential customers' timely access to service, LECs have undertaken investments which were motivated by social policy objectives, not business conditions and market characteristics. In particular, incumbent LECs have invested in network

²⁵ See, generally, AT&T, MCI, Telecommunications Resellers Association.

facilities that were deployed in rural, remote, and other high-cost areas to fulfill universal service obligations, even though consumer demand was low.

Regulation has traditionally ensured that LECs' prices for telephone service in these high-cost areas remained significantly below the levels required to make such investments profitable. Further, regulators have required LECs to depreciate these capital investments over relatively long periods of time, keeping recognized LEC expenses, and hence prices, as low as possible. Incremental cost estimates significantly understate the undepreciated value of a LEC's total network expenditures, particularly in high-cost areas, undertaken solely to meet regulators' carrier-of-last-resort and universal service objectives.

Using arbitrary and insufficient TSLRIC models for universal service determinations guarantees that eligible carriers will not be able to recover the joint and common costs of providing universal service from either customers or explicit funding. Congress understood that "joint and common costs" would be recovered in the pricing and support for universal service when it sought to ensure that universal service included no more than a "reasonable share" of those costs. Section 254(k). The Act does not permit ignoring the "joint and common" costs of providing universal service.

Those recommending TSLRIC could not provide, nor would they be willing to provide, stand-alone local exchange service in "high cost" areas at the very low rates recommended in their cost proxy models. Neither a firm's management nor its regulators can expect financial viability to result from equating output prices and the corresponding incremental costs, raising impermissible

takings issues. Beyond establishing a price floor,²⁶ incremental cost holds little to no relevance for determining the cost of universal service and whether explicit support is “sufficient.” While the universal service fund should be no larger than necessary, the Joint Board and the Commission must resist the temptation to make the fund as small as theoretically possible by ignoring the actual costs of providing universal service as done in certain TSLRIC-based models.

V. Funding

Some telecommunications carriers, after agreeing broadly that all telecommunications providers should contribute to universal support, suggest that only their particular classification of carrier should be totally exempt from any contribution whatsoever.²⁷ Although no relevant interstate revenue stream should be “taxed” twice for universal service support,²⁸ all interstate end-user revenue should provide the basis for universal service contributions, rather than completely exempting any such retail revenue. Applying an explicit surcharge once and only once on end-user retail revenues is the only way to achieve competitive neutrality.²⁹

²⁶ SWBT’s opposition to the use of TSLRIC advocated by the parties supporting the BCM is not an indictment of properly measured incremental costs. SWBT has a strong record in its State jurisdictions supporting the role of properly measured incremental cost for determining economic price floors. The proposed TSLRIC models backed by MCI are fatally compromised because, among other reasons, they incorporate arbitrarily insufficient allocations of joint and common costs.

²⁷ Reed Smith Shaw & McClay, pp. 10-11.

²⁸ See Vanguard Cellular Systems, Inc., p. 6, for complications that could arise in computations.

²⁹ BellSouth, p. 15; U S West, p. 17; NYNEX, p. 24; AT&T, pp. 7, 8; Harris, Shrivani & Associates, LLC, p. 8; Century Telephone Enterprise/TDS Telecommunications Corp., p. 16.

If funding is not made explicit, the goal of the Act to replace implicit support will not be met. If funding is instead based upon other methods, such as gross revenues net of payment to other carriers, then carriers presumably will have to raise their funding amounts using implicit means such as increasing rates. For example, if a LEC's access revenue is included within the funding base, that LEC would need to increase its access prices to recover its required level of funding. By doing so, the LEC will have re-created the very implicit support that the Act directs be eliminated. The only competitively-neutral manner to explicitly fund universal service support is to explicitly surcharge end-user retail transactions.

The vast majority of commenters expressing an opinion, including SWBT, agree that NECA should be recommended as fund administrator.

VI. Affordability

Several parties suggest that a definitive benchmark be established to assist in the determination of "affordability" called for by the Act, and as a threshold for high-cost support funding.³⁰ While the parties disagree on where this benchmark should be positioned and how it should work, the parties do recognize that such a definitive mechanism is essential to meeting the Act's mandate. AT&T argues that an affordability benchmark should be established based on current local exchange pricing levels plus an increased SLC price. This level is too low because this approach incorrectly assumes that basic local telephone service is currently appropriately priced. Before any consumer can expect others to help pay for universal service, that consumer should be required to first pay a reasonable and affordable price. An affordable price should be

³⁰ See, e.g., Ameritech, pp. 10-11; AT&T, pp. 15-17, Sprint, pp. 4, 9; USTA, pp. 14-16; U S West, pp. 12-13.

determined by comparison to the average consumer's spending on other goods and services as detailed in SWBT's Comments in this proceeding.³¹ An overall affordability benchmark set at 1% of the State's median income represents a proper balance among the needs for more appropriate cost recovery, appropriately sizing support funds and supporting high cost markets.

The USTA plan provides a reasonable way to implement the interstate portion of the affordability benchmark concept. By establishing an interstate affordability benchmark for SLCs at the nation-wide average loop cost as identified in the Base Factor Portion, the Commission will be able to advance the goals of more appropriate cost recovery, appropriately sizing support funds and supporting high cost markets.

VII. To Replace Implicit Support, Universal Service Areas Must Be Smaller Than Current Study Area Boundaries

Several commenters agree that universal service areas should be smaller than current study area boundaries. A minority believe that current study area boundaries, or even state-wide areas, should continue to be used to examine high costs. The Missouri Public Service Commission states that "[s]maller study areas might permit a large LEC to receive USF funding related to its high-cost areas, even though the LEC's overall costs were no higher than average."³² Such a position argues only for a continuation of the current state of affairs that Congress has decreed should cease. To remove implicit universal service support, costs must be measured over smaller

³¹ It is important to remember that overall spending on telecommunications services should not change by rebalancing prices. Today, Americans spend, on average, 0.6% of their income on basic telecommunications services and 2.0-2.5% in total. After rebalancing to a 1.0% affordability benchmark, Americans would spend, on average, 1% of their income on universal services and would be expected to still spend approximately 2.0-2.5% for lower priced telecommunications services.

³² Missouri Public Service Commission, p. 8.